

KERR-McGEE CORP.

IBLA 97-16

Decided January 29, 1999

Appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming a decision of the Chief, Royalty Valuation and Standards Division, denying approval of a retroactive transportation allowance for production from Lease Nos. OCS-G 3169, OCS-G 3168, and OCS-G 1528. MMS-93-0402-OCS.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982:
Royalties--Oil and Gas Leases: Royalties: Payments--
Outer Continental Shelf Lands Act: Oil and Gas Leases

A lessee is not entitled to Federal Energy Regulatory Commission Order No. 94 reimbursements for costs incurred in moving unmarketable gas from the wellhead to an accumulation, treatment, and sales point across lease boundaries in the field because such costs are "gathering" and not "transportation" costs and may be considered part of the lessee's gross proceeds for purposes of calculation of royalties.

APPEARANCES: Christopher A. Tytanic, Esq., for Appellant; Peter J. Schaumberg, Esq., Sarah L. Inderbitzin, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., and Lisa K. Hemmer, Esq., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE IRWIN

Kerr-McGee Corporation (Kerr-McGee) has appealed a July 12, 1996, decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), affirming a September 18, 1992, decision by the Chief, Royalty Valuation and Standards Division, MMS, denying approval of a retroactive transportation allowance for production from Lease Nos. OCS-G 3169, OSC-G 3168, and OSC-G 1528 for calendar years 1982 through 1986.

Background

Kerr-McGee's leases are in the Ship Shoal Area of the Gulf of Mexico Outer Continental Shelf (OCS) Region. For Lease OCS-G 1528

(Ship Shoal (SS) Block 233) the gas that surfaces on Platform A on the lease is moved approximately 1 mile to Platform H on adjacent Lease OCS-G 1529 (SS Block 214(H)). The gas is treated and sold on Platform 214(H). For Lease Nos. OCS-G 3169 (Platform A on SS Block 238) and OCS-G 3168 (SS Block 237), the gas surfaces on platforms on those leases and is moved to Platform 233(B) on adjacent Lease OCS-G 1528 (SS Block 233), where the gas is treated and sold. The gas that surfaces on SS Block 237 is moved first to Platform 238(A), about 4 miles, and then, together with gas from Platform 238(A), is moved to Platform 233(B), less than 2 miles. (MMS Answer at 16-17 and accompanying Exhibits A and C.)

On July 13, 1992, Kerr-McGee filed with the Chief, Royalty Valuation and Standards Division (Chief), MMS, a request for reimbursement of transportation allowances, pursuant to Federal Energy Regulatory Commission (FERC) Order No. 94, for the movement of gas production in these three pipeline segments. Kerr-McGee described these segments as (1) Kerr-McGee's pipeline connecting SS Block 238(A) to SS Block 233(B), (2) Kerr-McGee's pipeline connecting SS Block 237 and SS Block 238 to SS Block 233, and (3) Kerr-McGee's pipeline connecting SS Block 233(A) to SS Block 214(H) platform. Kerr-McGee stated that the reimbursable FERC Order No. 94 transportation costs collected for SS Block 237 and SS Block 238 to a sales point at SS Block 233 for the period 1982 through 1986 were \$308,083.17. It stated that reimbursable FERC Order No. 94 transportation costs from SS Block 233(A) to SS Block 214(H) were \$536,539.52. Kerr-McGee requested that these costs be deducted, under FERC Order No. 94 and MMS' June 18, 1992, Dear Payor letter, from the value of gross proceeds received.

FERC issued Order No. 94 and supplementary orders to implement section 110 of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. § 3320 (1988) (repealed effective Jan. 1, 1993). Section 110 of the NGPA excepted from the ceiling price set by the NGPA certain production-related costs, thus allowing producers to recover these costs in addition to the unit price for delivered gas from purchasers. Section 110(a)(2) provided for "any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by [FERC]." 15 U.S.C. § 3320(a)(2) (1988). Through its orders, FERC provided that a first sale of natural gas would not be considered to exceed the maximum lawful price if that first sale price exceeded the maximum lawful price by an amount necessary to recover production-related costs. 18 C.F.R. § 271.1104(a)(1) (1986). The term "Production-related costs" is defined to include "costs other than production costs that are incurred: (i) To deliver, compress, treat, liquefy, or condition natural gas * * *." 18 C.F.R. § 271.1104(c)(7)(i) (1986).

In 1991, in Mesa Operating Limited Partnership v. United States Department of the Interior, 931 F.2d 318 (1991), cert. denied, 502 U.S. 1058 (1992), the United States Court of Appeals for the Fifth Circuit

upheld the Department's position that FERC Order No. 94 reimbursements are royalty bearing. It described that position as follows:

[R]oyalties are due on the gross proceeds accruing to the lessee; the term "gross proceeds" includes payments for the costs of treatment including measuring, gathering, compressing, sweetening, and dehydrating "where such services are necessary to place gas in marketable condition," whether the costs are absorbed in the price the purchaser pays pursuant to the set NGPA ceiling or are ultimately borne by the purchaser under § 110; accordingly, where the purchaser reimburses the lessee for treatment costs in accordance with § 110 and the Order 94 regulations, these payments become part of the value of production (gross proceeds) subject to royalty.

Id. at 323. The court recognized that for decades the Department had interpreted the marketable condition rule as requiring that marketing costs cannot be deducted from gross proceeds before royalty is calculated. The court then stated at page 325:

As the Interior Board of Land Appeals stated in Arco Oil & Gas Co., [115 IBLA 393 (1990)], only such marketing allowances "as have been expressly recognized may properly be deducted from value [of production] for royalty purposes." As did the D.C. Circuit in California Co. [v. Udall], 296 F.2d 384, 388 (D.C. Cir. 1961)], in the context of this case we define "production" in the phrase "amount or value of the production" as meaning "gas conditioned for market." * * * The DOI-lessor simply obtains a flat percentage of all "gross proceeds" whether they be within the ceiling price or exceed it under § 110, obtaining more royalty where the lessee obtains a greater price, including costs reimbursements, from the pipeline purchaser.

(Footnotes omitted.)

MMS Decisions

In his September 1992 decision denying Kerr-McGee's request, the Chief distinguished between "gathering," which he described as the movement of production to a central treatment point where it is placed into marketable condition, and transportation of the production away from the lease, which is a matter relevant to determining the value of production for royalty purposes. He explained that MMS determined whether the movement of production was gathering based on whether the production being moved is bulk well stream production prior to initial separation or is gas production after initial separation. If it is the former, the movement is considered gathering. If it is the latter, MMS considers three other factors: (1) whether the movement is upstream or downstream of the royalty settlement point at which MMS OCS personnel have determined the production to be removed from the lease; (2) whether the production is at a quality

sufficient to meet contract pressure and water content specifications; and (3) whether the sales point is at a location away from the lease block at which initial separation occurs. According to the Chief, if the movement is "away from the lease and downstream of the royalty settlement point, or is away from the lease, upstream of the royalty settlement point, and at contract specifications, then the movement is considered transportation." However, "[i]f the movement to the sales point is on the same lease at which initial separation occurs, the movement will normally be considered gathering." (Decision at 2.)

The Chief ruled that the movement of production in the Kerr-McGee pipeline segments listed in its July 1992 request was the movement of "bulk production to a central point for accumulation and treatment prior to its delivery to the purchaser." The Chief noted that the approved point of royalty settlement for gas was on SS Block 233(B) for gas production from SS Block 237 and SS Block 238, as well as for gas production from SS Block 233(B); that the royalty settlement point was on SS Block 214(H) for gas produced from SS Block 233(A); that prior to these platforms the only field treatment equipment were test separators and supply scrubbers; and that further handling of the gas production was necessary to place it into marketable condition prior to delivery to the purchaser. "Thus, SS Blocks 233`B' and 214`H' contain the production facilities necessary to place the production into marketable condition prior to its measurement for royalty purposes," the Chief concluded. Id.

Kerr-McGee appealed to the Director of MMS. In its statement of reasons (SOR) to the Director, it argued that a lessee "is entitled to an allowance based on the cost of transporting gas from the field to the first point of sale." (SOR at 4.) It argued that the marketable condition rule, 30 C.F.R. § 206.152(i) (1990), 1/ is a rule of "condition," not of "location." Id. In support of its argument, Kerr-McGee quoted Petro-Lewis Corp., 108 IBLA 20, 35, 96 I.D. 127, 135 (1989): "Thus, while the Department has refused to allow a transportation deduction for costs incurred in transporting oil or gas to a selling point within the field, it has allowed reasonable transportation costs from the field to the first point of sale." Kerr-McGee stated that this language "certainly seems to be a description of the factual situation behind the request for transportation allowances by Kerr-McGee." (SOR at 4.) Kerr-McGee alleged that "MMS ha[d] internally verified that the allowance request by Kerr-McGee contained only segments of pipeline that moved gas from the field across lease boundaries to the point of sale." Id.

1/ That regulation states:

"(i) The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement. Where the value established pursuant to this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition."

Kerr-McGee further argued that the Chief's decision "seems to revolve around whether the treatment point is at or near the wellhead or at some other location." Id. at 5. Kerr-McGee asserted that, under the rationale of the decision, a lessee could "qualify for a transportation allowance simply by moving its treatment facilities from the point of sale off the lease back to the wellhead." Id. Finally, Kerr-McGee argued that the royalty in kind provision in its leases, which allows for reimbursement for the reasonable cost of transporting production to a delivery point, "also supports an allowance to the lessor for moving production in value to a more convenient delivery point." Id. at 6. In summary, Kerr-McGee argued that the Chief's decision

ignores the distinction between treatment to place production in a marketable condition and transportation of that production to a market. * * * [A] lessee is entitled to an allowance based on the cost of transporting gas off the lease to the first point of sale. * * * [T]he cost of transporting gas to the treatment point is not part of the lessee's obligation to place the gas in a marketable condition.

Id. at 7.

In the July 12, 1996, decision under appeal, MMS noted that SS Block 233(B) and SS Block 214(H) "contain the production facilities necessary to place the production into marketable condition" and that the "point of royalty settlement for gas, as approved by the MMS Gulf of Mexico OCS Region, is located at these platforms." (Decision at 1-2.) MMS stated that determining whether particular costs are deductible as transportation costs is not solely based on the marketable condition rule. In response to Kerr-McGee's argument that "the cost of moving the gas to its initial point of sale, regardless of location, is deductible," MMS stated that "the Petro-Lewis decision illustrates that deduction of pipeline-related costs may depend on the location of the initial sales point." (Decision at 2.)

To Kerr-McGee's argument that the Chief ignored the distinction between transportation and treatment, MMS stated that the decision was not based on the view that the costs were associated with treatment but rather "upon the fact that the costs are gathering-related expenses." Id. at 2-3.

MMS quoted from the Conservation Division Manual, effective May 10, 1974, through February 29, 1988, Part 647, Chapter 5, Transportation Allowances - Pipeline General, section 3D Allowable Costs, according to which "[n]ormal gathering expenses incurred by a producer on a lease, unit, or field in which the production is located are not allowable as transportation deductions." MMS cited the definition of gathering, for royalty purposes, stated at 30 C.F.R. § 206.151 (1995):

Gathering means the movement of lease production to a central accumulation and/or treatment point on the lease, unit or communitized area, or to a central accumulation or treatment point off the lease, unit or communitized area as approved by BLM [Bureau of Land Management] or MMS OCS operations personnel for onshore and OCS leases, respectively.

MMS ruled that the three pipeline segments "facilitate the movement of gas production to either of two central treatment facilities" and their costs "clearly fall within the definition of gathering-related costs." (Decision at 3.)

Appeal to the Board

Kerr-McGee's Notice of Appeal asserts its belief that the MMS decision "is erroneous in that it incorrectly construes the law and the department's own regulations." Kerr-McGee adopts its SOR on appeal to the Director of MMS and in response to the MMS decision adds that it recognizes the definition of gathering, but that "such recognition must parallel the most important distinction * * * between pre-1988 transportation and the marketable condition rule." (Notice of Appeal at 2.)

MMS contends in its Answer that, to qualify for a transportation allowance, production must be moved to a market remote from the lease or field. (Answer at 13.) MMS argues that "the very essence" of allowing transportation costs is that gas is transported to a market away from the lease or field. Id. at 14. MMS notes that in Kerr-McGee Corp., 22 IBLA 124, 127 (1975), (which cites The Texas Company, 64 I.D. 76 (1957), and California Co. v. Udall, *supra*) the Department "distinguished transportation to a selling point in the field from transportation out of the field to a market place." Id. at 15.

[1] The facts, as revealed by the record and narrated in MMS' Answer, are undisputed by Kerr-McGee. They indicate that Kerr-McGee's gas was accumulated and rendered marketable at the processing platforms in SS Block 214 and SS Block 233, and that the gas was sold at those locations. As stated in the Chief's September 1992 decision, further handling of the gas production was necessary, after its arrival at those platforms, to place it into marketable condition prior to delivery to the purchaser. Accordingly, Kerr-McGee's gas was not marketable prior to arriving at Platform 214(H) and 233(B), and the pipelines by which it arrived there are properly considered "gathering" lines. As stated above, the royalty regulations define "gathering" as the "the movement of lease production to a central accumulation or treatment point on the lease, unit, or communitized area as approved by BLM or MMS OCS operations personnel for onshore and offshore leases, respectively." 30 C.F.R. § 206.101; 206.151.

After reviewing the concept of gathering in Enron Oil & Gas Co., 122 IBLA 244, 235-39, 99 I.D. 20, 26-28 (1992), we concluded that there were three definitive attributes of gathering lines: (1) they move lease production to a central accumulation point; (2) they connect to gas wells; and (3) they bring gas by separate and individual lines to a central point where it is delivered into a single line. Id. at 238, 99 I.D. at 28, and authorities cited. The pipeline segments in this case possess these attributes.

In support of its appeal, Kerr-McGee has cited language from Petro-Lewis Corp., *supra* at 35, 95 I.D. at 135, which states that while the

Department has refused to allow a deduction for transportation within the field, it has allowed transportation costs from the field to the first point of sale. "Field" is defined as "a geographic region situated over one or more subsurface oil and gas reservoirs encompassing at least the outermost boundaries of all oil and gas accumulations known to be within those reservoirs vertically projected to the land surface." 30 C.F.R. § 206.101. The regulation states that OCS fields are named and their boundaries designated by MMS. MMS explains that it determines whether to grant a transportation allowance by looking at where the sale occurs, i.e., at a market remote from the lease or field or at an adjacent lease.

(Answer at 20.) In this case, MMS states, the gas from SS Block 233(A) is moved approximately 1 mile to Platform 214(H) on adjacent lease OCS-G 1529, where it is treated and sold, and thus "all movement of gas before sale is within the field." Id. at 16. The gas that surfaces on OCS-G 3169 and OCS-G 3168 is moved 6 miles and 2 miles respectively to Platform B on adjacent lease OCS-G 1528 where it is treated and sold. Id. at 17. We agree that, even though production is moved across lease boundaries, because it is treated and sold on adjacent leases the costs of moving it there are properly regarded as gathering, not transportation. Branch Oil & Gas Co., 144 IBLA 304, 306-8 (1998); Xeno, Inc., 134 IBLA 172, 180-81 (1995), appealed Civ. No. CV-95-142-GF-PGH (D. Mt. Dec. 26, 1995); dismissed (Mar. 18, 1997), appeal filed, No. 97-35517 (9th Cir. May 16, 1997); see Arco Oil & Gas Co., 112 IBLA 8, 10-11 (1989); Shell Oil Co., 70 I.D. 393 (1963). We conclude that MMS correctly determined that Kerr-McGee was not entitled to reimbursements for the costs of gathering and accumulating the gas under the circumstances of this case.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed.

Will A. Irwin
Administrative Judge

I concur:

James L. Byrnes
Chief Administrative Judge